THE ULTIMATE INSIDERS: WHEN EXECUTIVES SELL STOCK

Leveling the playing field

Key reform proposals place new focus on timing, disclosure

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When it comes to executive compensation, Peter Peterson is no crazed radical.

Peterson, chairman of the Blackstone Group investment firm, is a consummate insider, a former commerce secretary, top corporate executive and director of several companies.

But when he surveys the corporate landscape and looks at the huge stock awards that top executives have cashed in for billions of dollars--sometimes right before companies spiraled into bankruptcy--he's certain there has to be a better way.

"If you'd had much longer holding periods, and much larger holding requirements, you wouldn't have had these scandals, by definition," Peterson said in an interview.

While much of the outcry over CEO pay has focused on enormous option grants, critics inside and outside corporate America, including Peterson, are saying more attention should be paid to the other half of the equation: how and when CEOs cash in by selling those shares.

Inseparable from that, experts said, is what insiders know, when they know it--and when they buy and sell.

Peterson recently headed a blue-ribbon panel assembled by the Conference Board research group to recommend corporate governance reforms. Declaring that the options explosion "resulted in an enormous incentive to manage companies for short-term stock price gains," the group backed performance-based pay and encouraged executives to hold a large chunk of stock while in office.

One other key proposal: To avoid any appearance of impropriety, firms should require senior executives to provide advance notice of trades, letting the market "help correct problems of unjust enrichment."

When investors look at the enormous stock sales at failed and scandal-ridden companies, Peterson said, they have a right to be angry.

"If you think of it more broadly than the legal definition of inside information and say, `What is the public suspicious of?' you say they're suspicious that these guys knew something," he said.

Peterson had a brief, but up-close, exposure to just that: He sat on the board of ImClone Systems Inc. when former CEO Samuel Waksal learned of a regulatory setback for a key drug and tipped off relatives, ultimately leading to his guilty plea on insider-trading charges. Peterson sat on the ImClone board for only two months, and resigned shortly after Waksal's actions became known.

Other corporate insiders are pushing a variation of mandatory predisclosure of transactions, urging fellow executives to file with federal regulators, well in advance, written plans for periodic sales of stock, then announce and follow through on them. Under certain conditions, such plans make executives immune from insider-trading charges.

Bill Pearson, former CEO and chief financial officer of publicly traded radio station owner Broadcasting Partners Inc. and former chairman and CEO of Schaumburg-based Motorola Inc.'s Internet radio venture, Radiowave.com Inc., said executives face myriad tensions in deciding when to sell.

Although CEOs ought to have a substantial portion of their net worth in their company's stock, he said, they, like all investors, need diversified portfolios. Other factors complicate the decision to sell, he said, including what the executive knows about the company's prospects, and concern over what investors will think about the transaction.

"Anybody with any brains pays a lot of attention to what the public thinks of them," Pearson said. "In general, the prudent way to do it, and the way that smells best, frankly ... is to completely remove any timing issues and have it scheduled."

Pearson acknowledges that CEOs haven't exactly flocked to such programs, saying it's partly a matter of ego and self-interest. But, he said, the dramatically increased focus on corporate governance issues may push more in that direction.

"The pendulum has swung dramatically from four or five years ago," he said.

Many restrictions exist

In general, company insiders face other stock trading restrictions besides the overall obligation not to trade while knowing important, non-public information. Many firms allow trading only during certain windows--often for a few days after earnings are released--though they do make exceptions. Many require all trades to be approved by the company's general counsel.

Insiders also face a new disclosure burden: Regulators last year began to require trades reported within two business days, rather than several days or weeks as had been the case.

And, sometimes, sales aren't final: The Sarbanes-Oxley corporate governance law requires CEOs and CFOs to return proceeds of any stock sales up to one year after the filing of a financial report that is later restated due to fraud or misconduct.

The Conference Board panel, however, isn't alone in making new proposals to try to lessen the systematic advantages--and billions in added profits--executives have in their stock trades. Among the others:

- While more companies are requiring executives to hold a certain amount of stock--often expressed as a multiple of their salary--some activists want specific rules on how long shares must be held.

Brandon Rees, a research analyst at the AFL-CIO and prominent critic of outsized executive compensation, said companies should require executives to hold "a substantial majority" of their stock awards while in office.

"That's simply the best way to address it," he said.

Others want certain absolute levels of stock holdings, arguing they help remove much of the opportunity for huge profits.

"I'm not as concerned about someone selling as much as what they are keeping," said Paul Lapides, director of the Corporate Governance Center at Kennesaw State University near Atlanta and a corporate director himself.

- Some are taking the idea a step further, urging regulators to reinstate a rule, repealed in 1991, that required executives to pay cash to exercise options and hold the shares for at least six months.

Enron Corp. whistleblower Sherron Watkins raised the idea during a recent visit to Chicago to address internal auditors, saying it would emphasize executives' "running a very clean ship" and keep them from cashing out when they know trouble is brewing.

"Just making them hold their stock for six months seems like a great incentive for ethical behavior," she said.

- Indexing options, a perennial favorite of compensation critics, is receiving renewed attention--labor unions, in particular, are raising the issue in proxy voting at several companies this year. Tying options to long-term performance measures, critics said, could help reduce windfall profits for executives who sell before the bottom drops out at overvalued companies.

- Many other ideas have been floated, including one--especially popular with trial lawyers--to revise rules that have made it more difficult for investors to win damages in civil suits. Some recommendations are even more black and white: Insiders should not be allowed to trade anonymously on the open market; insiders should not be allowed to trade at all while in office; or, conversely, insiders should face no restrictions on trading.

The last is popular with some legal scholars. They argue investors are not hurt by any insider trading--essentially because it makes the market more efficient, guiding stock prices closer to theoretically ideal levels, as if all information were available.

"Some of the arguments ... were very logical as to why it was done as it was done" before insider-trading laws were enacted after the market crash of 1929, said Michael Painchaud, director of research at Seattle-based Market Profile Theorems, which analyzes insider transactions to make investment recommendations.

Intellectually intriguing? Perhaps. But don't hold your breath.

"I think it would be rampant manipulation" without rules, said Jim Hamilton, a senior law analyst and securities law expert at the Riverwoods-based CCH Inc. research group. "My feeling is there are victims. Anyone doing contemporaneous trading is a victim in a sense."

In general, several experts said, insiders face a Catch-22: It often looks bad when they time their sales especially well, particularly before a big drop in price, but investors may wonder about executives' competence when they time sales poorly.

Peterson, a former CEO at Bell & Howell Co., has been there, too.

"That's one of the reasons for advance notice--at least the market knows" what's going to happen, he said.

And ultimately, Painchaud said, most insiders are out to do the right thing.

"In my experience, they're not worse human beings, nor are they better human beings than we are," he said. "They have their investment life and they have their work life. In general ... they are longer-term in their vision when they are buying and selling."

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